CEO on Update

Open Briefing interview with CEO Sam Hupert

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In this Open Briefing®, Sam discusses:

- Continuing growth in North American business, major contracts to contribute in FY2016
- Sustainable growth in free cash flow generation
- Return to franked dividends in future as Australian earnings increase

Record of interview:

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Pro Medicus Limited (ASX: PME) today reported net profit after tax of $3.22 million for the full year ended 30 June 2015, more than double the previous year's NPAT of $1.51 million. Profit growth was well ahead of growth in revenue, which was up 21.7 percent to $17.58 million. What were the key drivers of the increase in profitability and is it sustainable over the longer term?

CEO Sam Hupert
There were two key drivers. First, as we've flagged previously, we expect our margins to be significantly higher as we deliver our new US contracts. That reflects our relatively fixed cost base, including R&D, which is to a large extent covered by our traditional service-based contracts. In FY2015 we saw those higher margins beginning to flow through.

The second driver was currency, as the US dollar has strengthened at the same time we're deriving more of our income from the US.

Whilst exchange rates may fluctuate we fully expect the higher margins to be sustainable as our US sales continue to ramp up.

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Top line growth was driven by the North American business, which reported revenue of $8.88 million, up 67.2 percent from the previous year. To what extent did this reflect contributions from the major contracts that you've won in this market in recent periods? To what extent did the growth reflect contributions from operational contracts as opposed to capital contracts?

CEO Sam Hupert
The year was one of transition, with the first tranche of our recent major US operational contracts being implemented but not yet fully contributing to revenue. While we saw some top line contribution from capital contracts and from the early phase implementation of those first operational contracts, particularly in the second half, we expect these contracts to start making a full contribution to revenue during the current financial year.

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North American EBIT of $0.08 million was down from $0.36 million in the previous year, with the business falling to an EBIT loss of $0.38 million in the second half, compared with profit of $0.80 million in the previous second half. What was behind the deterioration in North American profitability and can a turnaround be expected in the nearer term?

CEO Sam Hupert
The change in our North American earnings reflected our adoption of a new transfer pricing policy. We believe the new policy more accurately reflects the relationship of our different geographical entities, and particularly the fact that our IP is owned here in Australia.

Our North American business now pays the Australian business what we believe to be a fair market price based on a cost plus model whereas previously it paid a fixed percentage royalty. Like for like, the American business did very well, a trend we see continuing.

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You've previously flagged that the $20 million operational contract you won last year with a major US health network would be fully implemented in the current half, when you will start receiving payment for contracted minimum volumes as well as for any additional "views". Is the implementation on schedule and what is the outlook for volumes under the contract?

CEO Sam Hupert
This implementation has been going well but the time frame for the next phase of installation has been pushed out due to a holdup caused by a third party in the project. That won't change the ultimate revenue profile of the project, it will just change the timing slightly.

The contract had a positive impact on revenue in the second half and will have an even bigger impact in the current year. But the full contribution to revenue and earnings won't come through until we've fully implemented Visage 7 across that network – which will now be in the second half of FY2016. Then we'll also get the full impact of any additional views.

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Can you provide an update on your sales pipeline in the North American market?

CEO Sam Hupert
The pipeline continues to grow very strongly and we're very pleased with both the quantity and quality of the prospects available to us. Clearly, our growing recognition in the sector is helping. At the same time Visage's suitability in a wide range of environments is helping us connect with a broader field of institutions and practices.

We have opportunities at virtually every stage of the pipeline, from early stage discussions to near final negotiations.

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What is your view of the recent merger and acquisition activity in your sector such as IBM's buyout offer for medical imaging provider Merge Healthcare, announced earlier this month, and Fujifilm's acquisition in May of TeraMedica, a US provider of vendor neutral healthcare enterprise solutions?

CEO Sam Hupert
Over the last 12 months there's certainly been a high level of M&A in our space. Interestingly, the major acquirers are not the large legacy picture archiving and communication system (PACS) companies looking to consolidate the market, which was the case in the past. Rather, we're seeing big companies driven by a growing understanding of the value of opportunities in healthcare data and interoperability of electronic medical records.

For example, IBM announced that its acquisition of Merge was largely driven by the target company's installed base and the data mining opportunities it offered. Other big companies are looking for new opportunities in healthcare technology for big data/meta-analysis, data portability, patient centric health records and other non-traditional uses. Given that roughly 90 percent of the medical record is image, and our technology is integral to displaying the image, we think the recent M&A activity highlights the importance of our role in what has become a very dynamic industry.

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Can you comment on how Pro Medicus is positioned to face a potential increase in competition in its sector? What are your longer-term strategic priorities for the business?

CEO Sam Hupert
This has always been a highly competitive market, and new players with different value propositions as detailed above add to the mix. We think we have three very important strengths. First, our technology is a significant step up on others. Second, our user base is growing and is set to continue to grow. That footprint is becoming a significant asset in its own right. Third, given that the US market has developed with a large number of different systems, none of which "talk" to each other, connectivity and inter-operability are becoming increasingly important. The ability of our technology to share images, regardless of their size within, and importantly across different enterprises is a very powerful advantage.

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The Australian business booked EBIT of $3.72 million, up from $1.18 million in the previous year. Revenue was $6.26 million, up 1.9 percent. Inter-segment sales from Australia increased to $4.16 million from $2.62 million, suggesting the Australian EBIT growth was driven by royalty income from North America rather than product sales to local clients in Australia. Can you comment?

CEO Sam Hupert
Revenue and EBIT were boosted by increased royalty income from North America as a result of our new transfer pricing policy. Having said that Australian revenue did increase in its own right.

The Australian market is experiencing some uncertainty at the moment, with some big changes among the large radiology groups. In this environment we were pleased our Australian business was able to hold its own, and as the market settles down, we'd expect some new opportunities to emerge for us.

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There have been recent indications that medical imaging groups Integral Diagnostics (formerly Lake Imaging) and I-MED Network are preparing for IPOs. How would further corporatisation/consolidation in the sector impact your local business?

CEO Sam Hupert
While companies are in the process of an IPO, purchasing and technology decisions tend to be put on hold. I'd note however that both Integral (Lake Imaging) and I-MED are long-term clients of ours.

Clearly this adds to the uncertainty. We'll have to see how these planned IPOs and any subsequent M&A pans out, but assuming that these groups aim to grow and that one of the drivers of consolidation is efficiency, we think we're in a strong position given Visage RIS and Visage PACS are the respective leaders in their field.

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The European business booked EBIT of $1.23 million for the year, up 67.2 percent. Revenue was $2.35 million, down 16.3 percent. Most of the European EBIT and revenue were generated in the first half. Can you comment on the outlook for European revenue and earnings?

CEO Sam Hupert
The main reason for the increase in EBIT was that operating expenses in Europe were lower and that there were lower royalties paid to Australia given the lower sales revenue. Our European business at present relies on capital sales and OEM sales, which can tend to be a bit lumpy hence the first half bias.

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Net cash flow from operations was $4.18 million in FY2015, down slightly from $4.23 million in the previous year. This included a tax payment of $3.74 million relating to the sale of the Amira business in FY2013. Excluding that payment, operating cash flow was $7.92 million for the year. How indicative is this of the company's future cash generating capability?

CEO Sam Hupert
Given the operational contracts we already have in the US, and the growing annuity income stream they'll bring, we're confident we'll be increasingly cash flow positive into the future.

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As at 30 June 2015, Pro Medicus had cash in hand of $12.94 million, down from $15.26 million a year earlier. You've declared an unfranked final dividend of 1 cent per share, bringing the total dividend for the year to 2 cents, unfranked. Given that, excluding the tax on the sale of Amira, Pro Medicus would have generated enough free cash flow to cover its FY2015 dividend, and that dividends remain unfranked, what are your nearer term capital management priorities?

CEO Sam Hupert
We'll look to continue to build our retained earnings on the back of our increased cash flow. Also, we'd expect to resume paying franked dividends in the not-too-distant future given our new transfer pricing policy, which will see increased earnings flowing to Australia. That will result in increased tax paid in Australia and therefore a rebuilding of our franking account balance.

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Pro Medicus booked capitalised development costs of $5.36 million in FY2015, up slightly from $5.16 million. In light of the entry of majors such as IBM, Fujifilm and others into the space, what is your level of confidence that your current level of R&D spending will ensure your product suite remains competitive?

CEO Sam Hupert
We've always had large competitors in our space, including integrated system providers like GE, Philips and Siemens, and we've been able to compete successfully.

We believe our R&D spending is appropriate for the current business, although we may see incremental increases in future as we grow our contracts in the US. However, if there were a new project or the opportunity for a new product set that made sense for us, we might look to increase our development spending. Certainly we have the firepower to be able to do that, and we believe that's a significant advantage.

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Thank you Sam.

For more information about Pro Medicus, visit www.promedicus.com or call Sam Hupert on (+61 3) 9429 8800.

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